

F. PRIVATE BENEFIT, INUREMENT AND COMBATTING COMMUNITY DETERIORATION

1. Introduction

This article will survey the area of private benefit, inurement and private interest as it relates to organizations exempt under IRC 501(c)(3) as organizations formed for charitable purposes and undertaking activities that combat community deterioration. This area of the law confronts the exempt organizations specialist with difficult and subtle legal and factual questions because it is often a natural battleground where charitable ends may only be accomplished by benefitting to some degree persons who are not necessarily traditional objects of charity. For example, the community benefitted may well include a substantial number of persons who are comfortably off, or the method used to benefit the community may be best accomplished by channeling the funds through the hands of non-charitable interests such as for-profit businesses that will derive some direct or indirect benefit in the process.

Two issues arise in determining whether a particular organization is charitable within the meaning of IRC 501(c)(3). The first is whether the purpose is charitable. The second is whether the methods of accomplishing this purpose prevent recognition of exemption. If the activities result in prohibited inurement to an individual the organization cannot be exempt. If there is a possibility that the organization serves a private interest along with a public interest, or where the serving of public interests will also result in other than incidental or insignificant benefits to private interests, recognition of exemption may also be prevented.

2. Combatting Community Deterioration

An organization may be exempt as an organization described in IRC 501(c)(3) if it is organized and operated for one or more of several purposes enumerated in Reg. 1.501(c)(3)-1(d). Among the enumerated purposes is charitable, which is defined in Reg. 1.501(c)(3)-1(d)(2) as follows:

The term "charitable" is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term includes... [the] promotion

of social welfare by organizations designed to accomplish any one of the above purposes or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

The four specified purposes enumerated in this regulations section were included in order to define with some specificity the type of social welfare organizations eligible for 501(c)(3) status. To the extent that this goal of specificity was not realized, meaning may be given to these phrases by reliance upon historical interpretation, usage and social theories of community structure, stability and deterioration. It is clear, therefore, that a somewhat enlarged concept of charity appears in this social welfare provision of the regulations. If the essential purpose of an organization is the provision of social welfare by means of one of the four specified purposes, any strict requirement that all recipients of its benefits be members of a traditional charitable class is diminished or eliminated. Revenue Ruling 68-14, 1968-1 C.B. 243, which holds that a nonprofit organization formed to preserve and develop the beauty of a city is exempt under IRC 501(c)(3) since the effect of its activities is to combat community deterioration and lessen the burdens of government, exemplifies this concept because the organization's program had the broad effect of beautifying the whole city and benefitted all citizens and not just one class.

The concepts of social welfare as used in Reg. 1.501(c)(3)-1(d)(2) and as used in IRC 501(c)(4) are not exclusive of each other. The meaning of the term overlaps and causes some confusion in regard to the types of organizations that qualify for exemption under each of these sections. In order for an organization to be exempt under IRC 501(c)(3) as a social welfare organization it must meet the definition of charitable set forth in Reg. 1.501(c)(3)-1(d)(2). The consequence of this overlap in definitions is that some organizations engaging in social welfare activities that do not qualify the organization for exemption under 501(c)(3), because the activities do not rise to the definition of charitable (or because the organizations are action organizations within the meaning of Reg. 1.501(c)(3)-1(c)(3)), may well qualify for exemption under 501(c)(4).

In assessing an organization formed to promote social welfare under section 501(c)(3) by engaging in activities that combat community deterioration, it is important to examine the purposes and activities of the organization as well as the manner in which these activities will be carried out. Revenue Ruling 70-585, 1970-2 C.B. 115, states in situation 3, that an organization that formulates plans for the

renewal and rehabilitation of an area of a city where the median income is lower than other sections and the housing is old and deteriorated, and which sponsors a renewal project in that area of the city is exempt under section 501(c)(3). The organization's membership is composed of residents, businesses and community organizations in the area, and as part of its activities it purchased an apartment house to rehabilitate and rent to low and moderate families. The organization's activities combat community deterioration by assisting in the renovation of a run-down area. This contrasts with situation 4 in the same ruling. There an organization formed to build housing for rent to moderate income families at cost was held to be not charitable within section 501(c)(3) since its program was not designed to provide relief to the poor or carry out any other charitable purpose. In situation 3, apartments could be rented to some moderate income families because the other purpose of rehabilitation of a deteriorated area was being accomplished. Revenue Ruling 76-419, 1976-2 C.B. 146 deals with an organization that purchases land in a blighted area and converts it into an industrial park. Lots are leased at favorable rates to industrial tenants. These enterprises are required to hire and train people from this economically depressed area. By inducing industry to locate in an economically depressed area and hire the unemployed, the organization benefits the community. The creation of the industrial park combats community deterioration. This contrasts with Better Business Bureau v. United States, 326 U.S. 279 (1945), which states that an organization formed for the mutual welfare and improvement of business methods among merchants so the public could obtain proper and fair treatment with such merchants was not organized and operated exclusively for educational or scientific purposes because, although some of the activities were educational, the activities were not exclusively educational. The court stated that the presence of a single noneducational purpose, if substantial in nature would destroy the exemption. Here the nonexempt purpose was the promotion of business. The organization in Rev. Rul. 76-419, above, was inducing industry to lease lots in the industrial park only as a means of accomplishing its exempt purpose, to combat community deterioration. In Better Business Bureau, the organization promoted business as an end in itself and not to accomplish an exempt purpose.

Rev. Rul. 76-147, 1976-1 C.B. 115 dealt with an organization operating in an area where the median income was higher than in the rest of the city. The organization was formed to improve conditions in a community by identifying problems and encouraging their resolution. By engaging in community improvement activities, the organization is combatting community deterioration. This contrasts with Rev. Rul. 77-111, 1977-1 C.B. 144, which held that an organization formed to increase business patronage in a deteriorated area by

providing information about the shopping opportunities is not operated for charitable purposes and is not exempt under 501(c)(3). Increasing business patronage and reviving lagging sales are not charitable purposes. Rev. Rul. 74-587, 1974-2 C.B. 162, held that a nonprofit organization providing financial assistance to various businesses in a depressed area qualified for exemption under 501(c)(3). The funds were distributed to businesses or individuals unable otherwise to obtain funds due to the risk involved. The organization combatted community deterioration, and differs from the organization in Rev. Rul. 77-111, above, because the thrust was not to promote businesses but to accomplish a charitable purpose. The recipients of the financial assistance "are the instruments by which charitable purposes are sought to be accomplished." (1974-2 C.B. 163)

Revenue Ruling 68-655, 1968-2 C.B. 213, holds that an organization formed to promote racial integration in housing and stabilize neighborhoods is operating in a way that combats potential community deterioration. The organization operates in a neighborhood that is not deteriorated and attempts to stabilize racially changing areas by buying and reselling or leasing homes to families that will be compatible with the neighborhood and demonstrate the feasibility of an integrated neighborhood. This ruling is noteworthy because the organization combats potential, and not actual, deterioration, and because there are no income limitations imposed on the families buying or leasing the homes from the organization.

Rev. Rul. 80-278, 1980-42 IRB 8, indicates that in determining whether an organization is exempt under IRC 501(c)(3), the particular activities will be considered to determine whether the organization's purpose is charitable; the activities are not illegal, contrary to public policy, or in conflict with statutory restrictions; and the activities are in furtherance of the organization's exempt purpose and are reasonably related to the accomplishment of that purpose. The issue is whether the activity is appropriately in furtherance of exempt purposes and not whether the particular activity, in and of itself, would be considered charitable. The organization in question in Rev. Rul. 80-278 is one which accomplishes the exempt purpose of preserving and protecting the natural environment for the benefit of the public by instituting litigation as party plaintiff to enforce legislation. The activity of entering into law suits is not, in and of itself, charitable; however, in this instance it does further an exempt purpose and is reasonably related to accomplishing that purpose. Therefore, the organization qualifies for exemption.

The foregoing revenue rulings demonstrate the wide variety of activities encompassed in the phrase "to combat community deterioration." There do not as yet appear to be any firmly established limits as to what activities are acceptable,

or as to the type of community that may be the focus of these activities. The phrase covers the whole range of activities concerned with improving or maintaining a community. The goal to be accomplished is to combat deterioration and, as Rev. Rul. 68-655, supra, implies, there is no need that there be present deterioration; potential deterioration is sufficient. It is important that the activity further the exempt purpose of promoting social welfare by combatting community deterioration, and, as Rev. Rul. 80-278, supra, states, the activity itself does not have to be one that is considered to be charitable, but it must further an exempt purpose and be reasonably related to the accomplishment of that purpose.

Because of the overlap between the definitions of organizations exempt under IRC 501(c)(3) as promoting social welfare by combatting community deterioration and of organizations exempt under IRC 501(c)(4) as promoting social welfare, the differences between these must be examined to arrive at a proper definition of an organization exempt under 501(c)(3). Rev. Rul. 75-286, 1975-2 C.B. 210, held that an organization with membership limited to residents of a city block, and formed to preserve and beautify the public areas in the block, does not qualify for exemption under IRC 501(c)(3), but may qualify under 501(c)(4). The organization's activities promote social welfare because they beautify public property and, although limited to a particular block, they benefit the whole community. The standard under IRC 501(c)(4) is less stringent than the 501(c)(3) requirement. Under 501(c)(4) it is sufficient that the organization be operated primarily for the purpose of bringing about civic betterment and social improvement. However, the restricted nature of the membership and the limited area in which the improvements are made indicate that the organization serves the private interests of its members by enhancing their property. Therefore, the organization is not organized and operated exclusively for charitable purposes. This is distinguishable from Rev. Rul. 68-14, 1968-1 C.B. 243, which held that an organization formed to beautify a city qualifies for exemption under IRC 501(c)(3) because in that Ruling the organization had as its purpose the beautification of a whole city and not just the areas adjacent to members' residences. Rev. Rul. 76-147, supra, which dealt with an organization formed to improve housing in a specific area of a city, states that Rev. Rul. 67-6, 1967-1 C.B. 135, is modified to remove any implication that preserving or improving a community does not benefit a sufficiently broad segment of the public to be charitable. So long as the interests served are truly public in scope, then such activities may be deemed to confer a community benefit that the law regards as charitable within the meaning of IRC 501(c)(3).

3. Public Benefit v. Private Interest

In trying to resolve the issue of whether the interests served by an organization are public in scope so that the organization's activities confer a public benefit recognized as charitable in scope under IRC 501(c)(3), it is necessary to address the topic of private interests and the extent to which private interests may be served by an organization exempt under IRC 501(c)(3).

Reg. 1.501(c)(3)-1(d)(1) states, in part, that an organization is not organized or operated exclusively for one or more exempt purposes "unless it serves a public rather than a private interest. Thus... it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization or persons controlled, directly or indirectly, by such private interests."

An organization that serves a private interest other than incidentally is not entitled to exemption as an organization described in IRC 501(c)(3). Thus, although an organization's operations serve a public interest, exemption may be denied if private interests are also served. The determination of whether private benefit is merely incidental to overall public interest turns on the nature and quantum of the activity under consideration and the manner by which the public benefit will be derived. While the private benefit must be incidental both in nature and quantity, the extent to which private benefit will be acceptable will vary in each case, in direct relation to the degree of public benefit derived.

In determining whether an organization is operated for public benefit the initial question is whether the organization is in fact designed to achieve exempt purposes. This inquiry focuses on whether the operations of the organization are reasonably designed to accomplish exempt purposes and not on the manner in which they are accomplished. The emphasis should be on the organization's activities. If the activity may be deemed to benefit the community as a whole, insignificant private benefit will not detract from the exempt nature of the activity. Rev. Rul. 66-358, 1966-2 C.B. 218, held that an organization exempt under IRC 501(c)(3) may accept funds and land necessary to establish a public park from a donor corporation and retain exemption even though the donor kept a right to continue using a scenic view in the park as its corporate symbol. The public benefit derived from the park far outweighs the rather insignificant private benefit falling to the corporate donor from its continued use of the scenic view. This contrasts with Rev. Rul. 72-102, 1972-1 C.B. 149, in which an organization formed to provide housing to low income families, was held not to be exempt under IRC 501(c)(3) because it gave preference to low income families employed on a farm

owned by the individual who created and controlled the organization. The Rev. Rul. reasoned that, even though the organization was providing housing for low income families, the fact that all families occupying the housing were farm employees of the creator of the organization demonstrated that the organization was operated for a private benefit. Rev. Rul. 70-186, 1970-1 C.B. 128, addresses the same issue. An organization formed to preserve and improve a lake qualified for exemption under IRC 501(c)(3) even though there would be private benefit to lakefront property owners. The benefits derived from the organization's activities flowed principally to the general public, to whom the lake was available. Any private benefits derived by the lakefront property owners did not lessen the public benefits, and it would be impossible to accomplish the exempt purpose without providing some measure of benefits to the lakefront property owners. (Contrast this to Benedict Ginsberg and Adele W. Ginsberg v. Commissioner, 46 T.C. 47 (1966), cited in the Rev. Rul., in which the court found no public benefit in the dredging of a waterway because the general public had no direct access to the water, and the owners of waterfront property were assessed dredging costs based on the amount of property owned. This demonstrated to the court that the dredging was undertaken by the waterfront owners primarily to benefit themselves and not the general public).

This line of reasoning is applicable to organizations operated to combat community deterioration. In order for such an organization to be exempt under IRC 501(c)(3), its activities must accomplish an exempt purpose and must benefit a sufficiently broad segment of the public as to be seen as charitable in nature and not merely serving private interests.

Such an organization must establish that it does not provide preferential services or benefits to its members other than those of a purely incidental nature. The organization must serve public rather than private interests. Absent such qualification an organization may not be deemed to be "organized and operated exclusively for... charitable purposes" under the interpretation in Better Business Bureau, cited above. In the case of organizations recognized as exempt under IRC 501(c)(3), services or benefits a member may receive as a consequence of joining the organization must be incidental to the charitable purpose of the organization or otherwise insubstantial in nature. Such an organization will not be viewed as fulfilling charitable purposes where it merely promotes the interests of its limited membership by providing benefits to these members. IV A. Scott, The Law of Trusts section 375.2 (3rd ed. 1967). A membership organization formed to enable its low income members to purchase decent housing is not exempt under 501(c)(3) because it serves the private interests of its members. Such an organization would

be charitable if the low income families to which it provided decent housing had no relationship to the organization or those who controlled it, as in Rev. Rul. 70-585, 1970-2 C.B. 115. However, where the members of the organization receive the housing, the benefit is to the members and not to the public. Where a public interest is not served or is served only secondarily or incidentally, there can be no exemption under 501(c)(3). Section 384 of the Exempt Organizations Handbook (IRM 7751) contains a useful discussion of some of the signals of private benefit to look for on an audit. Briefly, these include excessive payments to insiders, self-dealing, income sharing deals, absence of a reasonable return of corpus, vague or obscure purposes pursued in a dilatory fashion, or purposes that do not seem to fill a genuine public need.

4. Inurement

IRC 501(c)(3) provides for the exemption of organizations "organized and operated exclusively for...charitable...purposes...no part of the net earnings of which inures to the benefit of any private shareholder or individual."

The issue of inurement to the benefit of any private shareholder or individual focuses on benefits conferred on an organization's insiders through the use or distribution of the organization's financial resources. This differs from the private benefit analysis which considers the scope of the class to be served by an organization's otherwise exempt activities. Inurement is concerned with the direct transfer of income or provision of services unrelated to exempt purposes. IRC 501(c)(3) prohibits inurement to any "private shareholder or individual." That phrase refers to persons having a "personal and private interest in the activities of the organization." Reg. 1.501(a)-1(c). The reference to private individuals is intended to limit those persons who personally profit from an organization to the intended beneficiaries of the exempt activities. Kemper Military School v. Crutchley, 274 F. 125, 127 (W.D. Mo. 1921). Earnings do not inure to the benefit of a stockholder or individual in his private capacity when they inure to him as a member of the community being benefited or as a member of the public. Therefore the capacity in which an individual derives financial benefit, as well as the source of the benefit will be factors in determining whether prohibited inurement exists.

Inurement is likely to arise where the financial benefit represents a transfer of the organization's financial resources to an individual solely by virtue of the individual's relationship with the organization without regard to accomplishing exempt purposes. On the other hand, if financial benefit is derived from an individual's participation in an activity which furthers exempt purposes, the benefit

may be characterized as merely incidental to the public purposes served. This benefit may be a necessary by-product of an organization's permitted use of specific individuals as vehicles by which public purposes are served. In this connection, an exempt organization may confer direct financial benefits on people who are not themselves recipients of charity if these peoples' activities further public purposes. Rev. Rul. 74-587, 1974-2 C.B. 162, demonstrates this. An organization provides loans and working capital to corporations and individuals unable to obtain funds from conventional sources because of the risk of establishing businesses in depressed areas. The recipient starts a business or else acquires or improves an existing business in a depressed area. The organization's purpose is to combat community deterioration by helping to establish or rehabilitate businesses in a depressed area. Although some of the individuals receiving financial assistance might not themselves qualify for charitable assistance as such, this does not detract from the charitable nature of the program. The recipients of these funds are merely the instruments by which a charitable purpose is accomplished. Such cases are likely to present close questions in which all the facts must be carefully analyzed to determine the immediacy or remoteness of the public benefit and its relative significance as compared to any (incidental) private benefit or inurement of income.

In this Rev. Rul. each individual recipient of funds was participating in an exempt activity and acting in the public interest rather than in his or her private capacity. The participant was a representative of the public and any financial benefits derived from the activity are merely those necessary to the organization's successful operation for public purposes and do not represent inurement or private use of the organization's resources. In contrast to this, inurement might be seen in an individual's direct receipt of financial benefits irrespective of participation in an exempt activity or payments in amounts which bear no relationship to those reasonably associated with such participation.

Another example where the possibility of inurement arises is in regard to an organization that restores or rehabilitates deteriorated housing by granting loans to individuals who own the homes, or buys homes, restores them and then undertakes to sell the homes or finance their sale. These organizations must be scrutinized to insure that any benefits accruing to the individuals receiving the loans or buying the homes bear some relationship to the recipients' participation in the exempt activity of combatting neighborhood deterioration. The benefit received by the individuals, such as loans at lower than normal interest rates or financed sales of the homes, must be merely incidental to the public purposes served by the organization's activities.

5. Conclusion

In attempting to determine whether a particular organization is exempt under IRC 501(c)(3) as a charitable organization formed to combat community deterioration there are several basic issues that arise. The first of these is to determine whether the purpose of the organization is charitable as the term is defined in the regulations under IRC 501(c)(3). Rev. Rul. 77-111, supra, demonstrates that even though an organization's activities may contribute to the achievement of charitable purposes the facts may show that the overall thrust and end result would be the achievement of non-exempt purposes -- in this rev. rul., the benefit of private businesses. An organization's activities must be in furtherance of the charitable purpose and reasonably related to the accomplishment of that purpose. Charitable purposes cannot be accomplished as a mere by-product of the organization's activities as in Rev. Rul. 77-111. For example, in Benedict Ginsberg, 46 T.C. 47, the petitioners claimed that their activities of dredging certain waterways would benefit the entire community, but the Tax Court found that their activities did not support that claim. One fact considered by the court was that there was a correlation between contributions solicited and benefits to be derived.

Once the organization's activities are found to combat community deterioration, then it must be determined that the organization serves a public interest and does not serve private interests except to an insignificant degree. In conjunction with this, a determination of whether the organization's activities result in prohibited inurement to private individuals must be made. The revenue rulings cited in the area of private interests and prohibited inurement indicate that there is an acceptable level of private benefit that these organizations may serve, so long as it is incidental both in quality and in quantity when compared to the public benefit served. The fact that insignificant private interests are served will not affect exemption if the serving of these private interests is a necessary by-product of the serving of public interests. Rev. Rul. 70-186, supra. This is essentially a weighing test which must be applied to the interests served to weight the private interests as opposed to the public interests and then to determine how necessary these private interests are.

In the area of inurement to private individuals, it is necessary to determine whether the inurement is prohibited and thus will jeopardize exemption, because it consists of inurement of the organization's funds, or the provision of services to a person in his capacity as a private individual. Incidental financial benefit accruing

to an individual solely because of that person's participation in an activity that furthers the organization's exempt purpose, will not affect the organization's exemption. The fact that an owner of a recognized historic residence in a depressed area receives a loan at a favorable interest rate in order to restore the home may not affect the exemption of the organization providing the loan in an arm's-length transaction. The surrounding circumstances such as the homeowner's income, the restrictions the organization places on the resale of the home or the changes that can be made to the home, and the relationship between lender and borrower all will be considered in concluding whether the benefit to the individual recipient will be so insignificant in nature as not to amount to inurement.